MSCI ESG Research

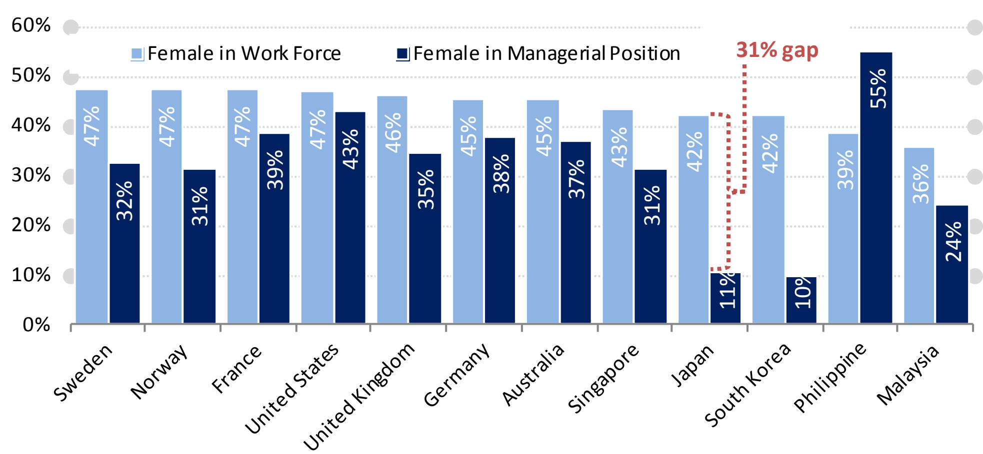
ESG Country Report: Identifying Key ESG Risks in Japan

March 2014

KEY FINDINGS

- As part of Abe's Japan Revitalization Strategy, Japan's institutional investors will soon be expected to focus on extra-financial factors such as corporate governance, corporate strategy, environment and social risks in their investments. Similar to the UK, the Financial Service Agency (FSA) will take a 'comply or explain' approach in requiring investors to meet the 7 principles of the Japan Stewardship Code.
- While currently only 13% of board members are independent at Japanese companies (versus 54% for companies in MSCI's All Country World Index), the composition of Japanese boards are poised to change given increased pressure from investors, particularly as foreign investors with stronger expectations of board transparency have steadily increased their share ownership. Healthcare and IT companies have the highest percentage of independent board member among Japanese companies.
- A key plank of the 'Abenomics' platform is to allow Japanese companies to leverage more flexible, lower-cost temporary workers in the domestic market. Temporary workers as a percentage total work force have increased from 16.4% in 1985 to 35.2% in 2012. With almost one-third of temporary workers being under the age of 45, the lack of training and investment in a new generation of workers could impede future innovation and the pipeline for managerial talent.
- An anemic talent pipeline could impede another of Abe's stated goals, namely his target to increase female representation among managerial ranks to 30% by 2020, from just over 10% in 2009. Given that only 20% of workforce is permanently employed female workers, Japanese companies will likely face significant challenges in identifying appropriate female candidates for leadership positions.

FIGURE 1 Comparison of Selected Countries on Percentage of Women in Managerial Position



Source: Cabinet Office, Government of Japan, Ministry of Internal Affairs and Communication, The Japan Institute for Labour Policy and Training

TOP RATED	BOTTOM RATED
NTT DOCOMO	Tokyo Electric Power
OMRON	GREE
NKSJ Holdings	ACOM
Sekisui Chemical	Sumitomo Realty
OSAKA GAS	OLYMPUS
INPEX	YAMATO KOGYO
Hitachi Chemical	Keisei Electric Railway
TEIJIN	Maruichi Steel
LAWSON	JAPAN TOBACCO
SYSMEX	SHIMANO
TOSHIBA	Iida Group Holdings

SCOPE

This report summarizes key findings of MSCI ESG IVA research covering 320 constituents of the *MSCI Japan Index*.

REPORT CONTENT

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THE LABOR MANAGEMENT

Key Takeaways

- Temporary workers have doubled since 1985, and in the last 10 years, 32% more workers aged 25-34 (prime career-building years) have been hired as temporary workers rather than employees.
- While hiring temporary workers generates an estimated 24% discount in labor cost in the short term, the hidden cost to these savings is the gap in management-ready employees available to these firms. We identified key industries at high risk of disenfranchised workers and an anemic talent pipeline.
- While Food Retail companies continue to be tarnished as "black companies" (companies with sweatshop-like operations exploiting newly graduated workers), Education Services and Real Estate may also face increasing pressure to limit employee burnout or risk public censure.
- The issues with temporary workers are compounded in industries where collective bargaining is strong, such as in the manufacturing industries, and there may be a perfect storm for social disruption in an otherwise dispute-free society.

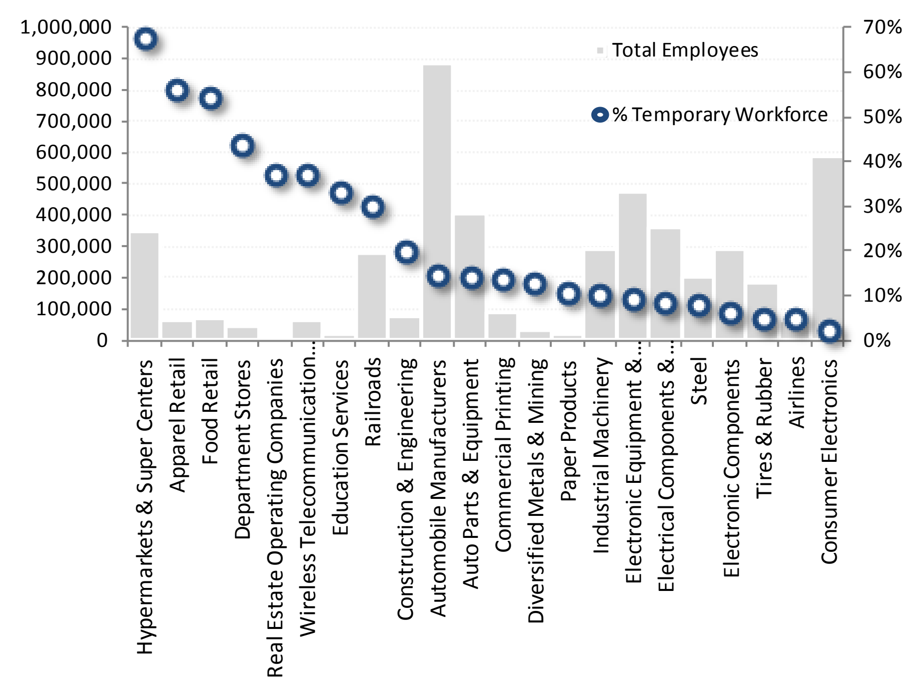
Abe's emphasis on increasing global competitiveness is at odds with continued reliance on temporary workforces, and companies will increasingly face challenges finding long-term management candidates domestically.

In 2013, 37% of the Japanese workforce was "non-regular" – temporary employees increasingly used by companies to avoid paying permanent employees in Japan's "lifetime employment" human capital structure. Temporary workers have doubled since 1985, and in the last 10 years, 32% more workers aged 25-34 (prime career-building years) have been hired as temporary workers rather than employees. After 20 years of relaxing regulations on temporary hiring practices, **a third of the Japanese workforce has received minimal management training leaving high skill, labor intense industries at a long-term competitive disadvantage** despite the cost savings of using short-term temporary workers.

Measuring the Human Capital Tradeoff

MSCI ESG Research analyzed data from the Japanese Ministry of Internal Affairs and Communications and Ministry of Health, Labor, and Wealth to estimate potential cost savings for temporary workers given wage gaps and temporary workforce growth. Between 2002 and 2013, temporary workers grew at a compound annual rate of 2.2% (compared to a 1.1% annual decrease in regular employees in the same time), a direct reflection of a decade of employment deregulation. While temporary workers over the age of 55 grew at the largest rates (highlighting the country's aging populace), 25-54 year olds still make up nearly 70% of the workforce, and the temporary workforce hires outpaced regular employee hires in that age bracket by an average of 1.2 to 1. In 2013, hiring these employees on a temporary basis generated a 24% discount to hiring regular employees. If the growth rate persists over the next decade, Japanese industries reliant on temporary workforces could save as much as 25-30% on employment costs over the next five years.

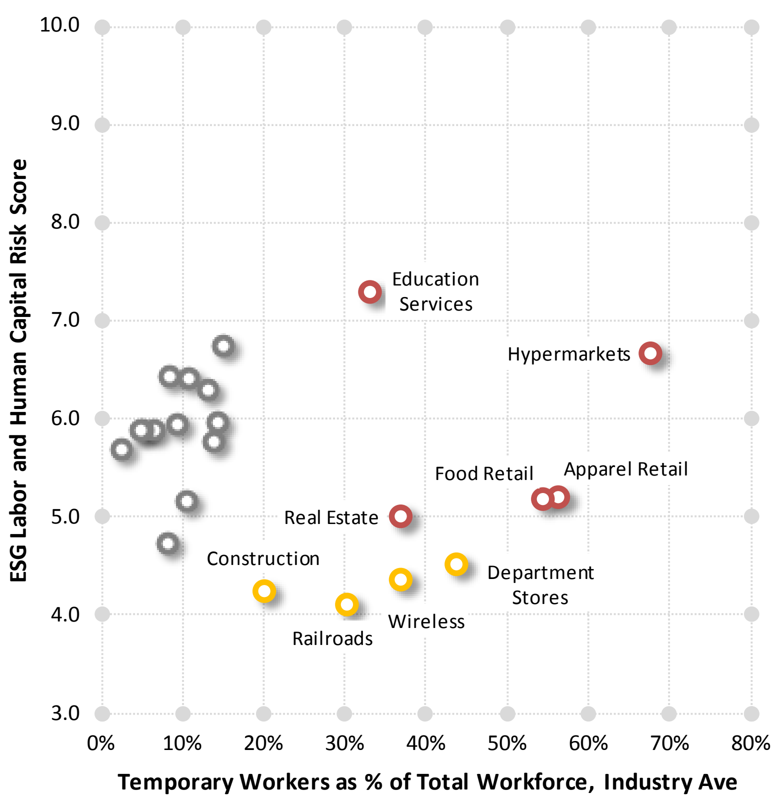
FIGURE 2 Temporary Workforce Prevalence, 2013



Source: MSCI ESG Research

However, **the hidden cost to these savings is the gap in management-ready employees available to these firms**. More than 22% of the Japanese workforce is over the age of 55 with a growth rate that outpaces every other age segment. In 2002, 11% of career-prime aged workforce, defined as workers between the ages of 24 and 44 where the majority of talent and management training is established, was hired on a temporary contract compared to 13% in 2013. When we overlay our labor and human capital risk scores with temporary workforces, a few industries stand out at greater risk of potentially disenfranchised employees, particularly if temporary workforces increase at the expense of regular employees. Figure 16 highlights industries with heavier than average temporary workforce reliance and higher than average human capital and labor risk scores for Japanese companies in the MSCI World Index.

FIGURE 3 Labor and Human Capital Risk Scores vs. Temporary Workforces, 2013



Source: MSCI ESG Research

While Food Retail companies continue to be tarnished as “black companies” (companies with sweatshop-like operations exploiting newly graduated workers), Education Services and Real Estate may also face increasing pressure to limit employee burnout or risk public censure. Both require a mix of highly trained employees, and both sectors have increasingly relied on temporary workforces as stop gaps. Some academic research have estimated that temporary workers could be as much as 75% less productive and significantly less specialized, with negative correlations between temporary workers and exports and temporary workers and output efficiency metrics, posing long-term problems for these sectors inevitably in need of career talent as management turns over.

These issues are compounded in industries where collective bargaining is strong, and there may be a perfect storm for social disruption in an otherwise dispute-free society. Manufacturing, particularly automobile manufacturing, fits this profile, with a growing proportion of temporary workers and strong unionization. Fuji Heavy Industries, 42% unionized, anticipates hiring 10% of its workforce as temporary in 2014, and both Toyota and Mazda increased temporary workforces by 60% and 30% since early 2013.

Ultimately, the ability of these firms to add and terminate employees quickly through temporary workers is both a boon and a curse, as the workers themselves have little incentive to consider long-term sustainable outcomes for their firms.

For a discussion on labor in the supply chain of Japanese companies, please see Issue Brief: Country Spotlight Japan.

ESG SNAPSHOT: GOVERNMENT

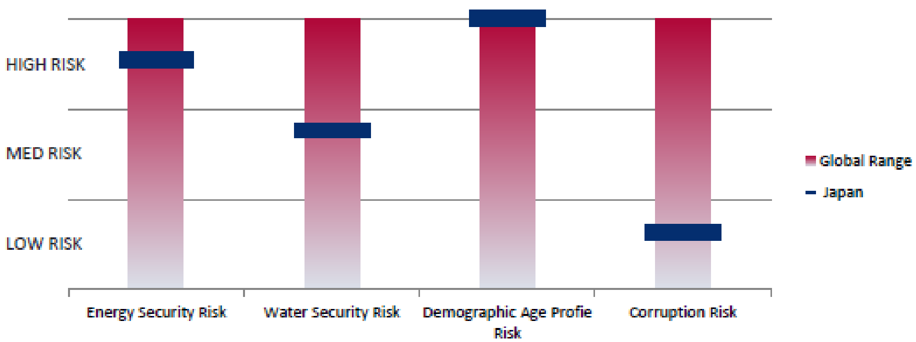
2012 ESG Sovereign Rating: A
Score: 6.11

2013 ESG Sovereign Rating: A
Score: 5.95

2014 ESG Sovereign Rating: A
Score: 5.82

According to our ESG Sovereign Ratings, Japan ranks 30th out of 133 rated countries. Japan's debt-to-GDP ratio (215%) is among the highest globally which arguably leaves small margin for error for Japanese policymakers. Energy security and an aging population feature as prominent risks. Japan relies heavily on China for both imports and exports (one fifth of all trade in 2013). We noted that Japan imports 80% of its energy requirements, adding to energy security risks.

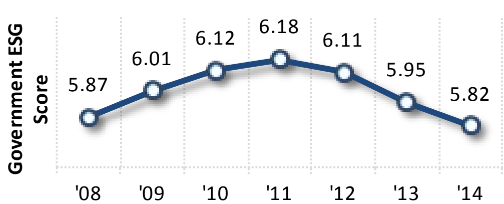
FIGURE 1 Major ESG Risks in Japan vs. Global Range, 2014



Source: MSCI ESG Research, Government Rating

The trend of Japan's score has been worsening since 2011 (figure 2). The overall rating has been buoyed by the country's emphasis on human capital (the "lifetime employee" system), but policy changes have eroded these strengths over the last two years.

FIGURE 2 Japan ESG Score History, 2008-2014 (0-10 Range)

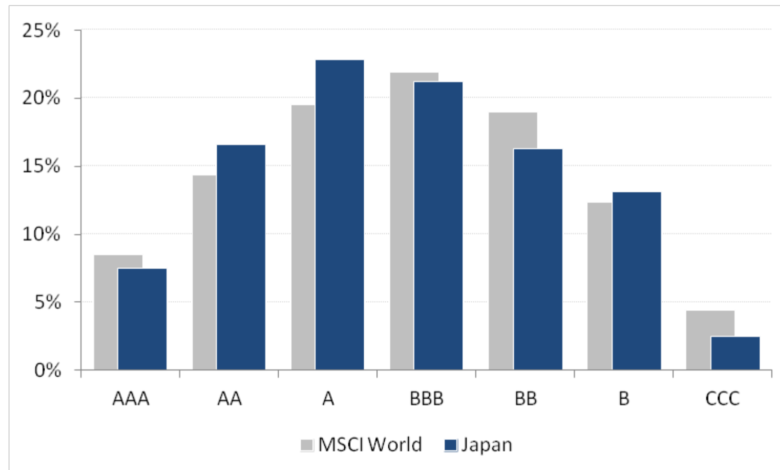


Source: MSCI ESG Research, Government Rating

ESG SNAPSHOT: CORPORATE

MSCI ESG Research analyzes the constituents of MSCI Japan Index annually, covering 320 companies in 2013. The figure below shows the rating distribution of MSCI Japan against that of MSCI World Index, showing a rating distribution that is closely in line with the MSCI World Index. (see figure 3).

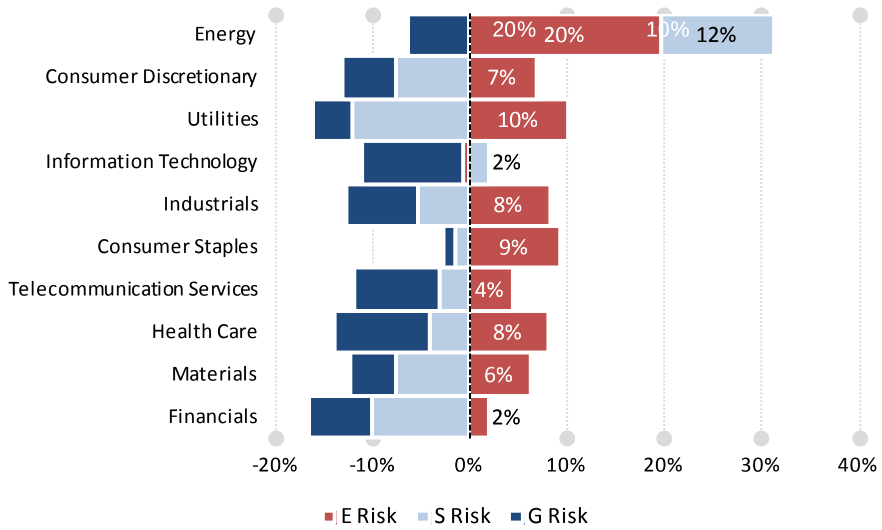
FIGURE 3 ESG Rating Distribution Japan vs. MSCI World Index



Source: MSCI ESG Research, IVA Rating

At a sector level, the majority of this risk differential seems to be borne by the Energy sector (20%), with revenues heavily reliant on earthquake exposed nuclear generation and imported coal. However, the lack of a reliable domestic energy source, country size, and waste management issues trickle through virtually every industry. Unlike other industries, however, both Energy (10%) and Materials (2%) sectors tend to face greater social risks than MSCI World Index counterparts, where toxic releases and spills are likely to have more acute effects on the population, ecosystem, and food supply (see figure 3).

FIGURE 4 JP ESG Risk Scores vs. MSCI World Index ESG Risk Scores by Sector



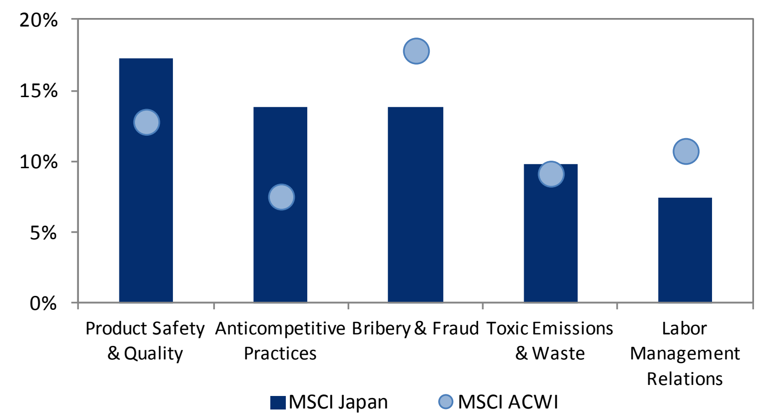
Source: MSCI ESG Research, IVA Rating

FIGURE 5 ESG Momentum: Top Movers, 2012-2013

Company	Current Rating	Prior Rating	1 Yr Momentum
Fuji Heavy Industries Ltd.	**AA**	**BBB**	⬆⬆
Hankyu Hanshin Holdings,Inc.	**A**	**BB**	⬆⬆
ITOCHU Corporation	**A**	**BB**	⬆⬆
Keikyu Corporation	**BBB**	**B**	⬆⬆
Odakyu Electric Railway Co.,Ltd.	**BBB**	**B**	⬆⬆
SUMITOMO CORPORATION	**A**	**BB**	⬆⬆
TOKYU CORPORATION	**A**	**BB**	⬆⬆
ISUZU MOTORS LIMITED	**B**	**BBB**	⬇⬇
SUZUKI MOTOR CORPORATION	**B**	**BBB**	⬇⬇

Looking at companies exposure to controversies related to global norms and international conventions, our analytics of found that 17% of Japanese company controversies are related to product safety and quality issues, compared to 13% for MSCI ACWI. Furthermore, anticompetitive practices account for 14% of total controversies our research captured compared to 8% of all MSCI ACWI controversies. (see figure 6)

FIGURE 6 ESG Ratings Comparison: JP Ratings vs. MSCI World Index Ratings

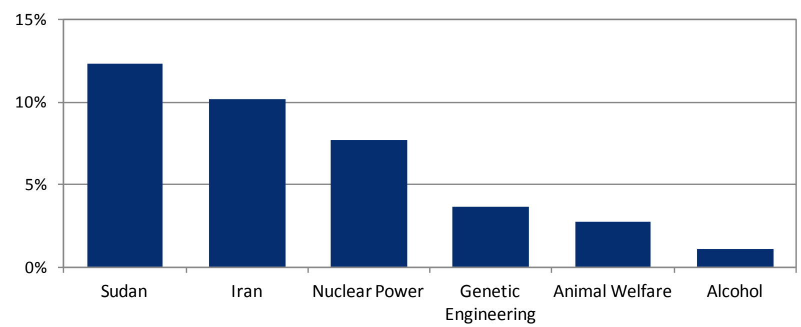


Source: MSCI ESG Research, Impact Monitor

ESG SNAPSHOT: BUSINESS INVOLVEMENT

Our analytics of Japanese companies' exposure to unethical business involvement indicates that 22.6% of Japanese companies have business involvement in countries subject to global sanctions, including 10.2% to Iran and 12.4% to Sudan (figure 7). A large portion of this exposure can be traced to the business activities of two companies: **Toyota Motor** and **Mitsubishi UFJ Financial Group**.

FIGURE 7 Top 5 Exposures to Unethical Business Involvement: MSCI Japan Index



Source: MSCI ESG Research, Business Involvement Screening

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The company's flagship product offerings are: the MSCI indexes with approximately USD 8 trillion estimated to be benchmarked to them on a worldwide basis[1]; Barra multi-asset class factor models, portfolio risk and performance analytics; RiskMetrics multi-asset class market and credit risk analytics; IPD real estate information, indexes and analytics; MSCI ESG (environmental, social and governance) Research screening, analysis and ratings; ISS corporate governance research, data and outsourced proxy voting and reporting services; and FEA valuation models and risk management software for the energy and commodities markets. MSCI is headquartered in New York, with research and commercial offices around the world.

[1] *As of September 30, 2013, as reported on January 31, 2014 by eVestment, Lipper and Bloomberg* *Feb 2014*